EDITORIAL
SEEKING A DURABLE RECOVERY FOR ALL

The global recovery is becoming self-sustained and more broad based. The recovery is taking place at different speeds, between advanced and emerging economies, but also within the first group of countries. Unemployment remains high across most of the OECD countries. In most, headline inflation has risen strongly, and expectations are also drifting up; however, underlying inflation seems likely to edge up only slowly. Vibrant domestic demand growth, negative supply shocks and strong capital inflows in non-OECD economies are generating inflationary pressures prompting policy restraint that could slow the recovery.

Such a scenario calls for differentiated policy responses in advanced and emerging economies. In both groups of countries structural reforms should play a key role while taking into account country-specific needs and institutional features. In advanced economies, structural reforms can boost potential growth, thereby facilitating fiscal consolidation and easing the pace of monetary policy normalisation. In emerging economies, monetary policy should tighten more to curb inflation, but this option risks being constrained by inducing stronger capital inflows. In emerging economies, structural reforms could make growth more sustainable and inclusive, while contributing to global rebalancing and enhancing long-term capital flows.

The outlook is surrounded by risks. Some of them are endogenous to the pace of expansion; others are associated with the possibility of specific events. Upside risks include unexpected short-term stimulus from additional structural measures and more buoyant private-sector activity as confidence increases. Some of the risks are two-sided. Oil prices may rise or fall back over the projection period. While the earthquake and tsunami in Japan could have additional negative consequences on activity further reconstruction packages could hasten the rebound. Most risks are on the downside, however, including: further increases in oil and other commodity prices which could feed into core inflation, a deeper slowdown in China, an unsettled fiscal situation in the United States and Japan and renewed weakness in housing markets. Financial vulnerabilities are increasing in the euro area in spite of strong adjustment efforts in peripheral countries. A concern is that, if downside risks interact, their cumulative impact could weaken the recovery significantly, possibly triggering stagflationary developments in some advanced economies.

All this suggests that the global crisis may not be over yet. Policy makers must intensify efforts to deal with medium-term challenges. Four such challenges stand out: dealing with high unemployment and preventing it from becoming entrenched; sustaining growth and avoiding stagnation; making progress in fiscal consolidation; and managing global imbalances while supporting orderly saving reallocation. These challenges are interconnected and require a comprehensive and credible policy approach.

While the recovery is bringing some improvements in labour market conditions in advanced economies, total, and especially long-term, unemployment remains high in many countries. Also drawing on lessons from the crisis, labour market policies have a key role to play in preventing cyclical unemployment from turning structural. Such policies could include more effective placement services with training to match workers and jobs; rebalancing employment protection towards temporary workers;

and temporary reduction in labour taxation through well targeted marginal job subsidies in countries where labour demand is weak. The employment impact of such measures would be boosted by stronger competition in sectors such as retail trade and professional services. Moreover, the crisis has demonstrated the utility of well designed work-sharing arrangements in minimising employment loss during downturns.

Return to work and competition-enhancing measures would also contribute to stronger potential growth, which could otherwise remain weak. Indeed, as experience shows, following financial crises there are risks of stagnation as structural adjustment and financial repair are delayed. Stagnation could also emerge from persistent deterioration of the structural and business environment. Even if such risks do not materialise the impact of the crisis in lowering potential output is becoming clearer. Such permanent output loss could, eventually, lower realised growth rates. The potential for growth-enhancing structural reforms and policies to unleash new sources of growth is substantial. Governments should intensify their efforts in implementing them.

Lower growth would feed back negatively on fiscal consolidation, while evidence shows that, beyond some thresholds, public debt levels have a negative impact on growth. In spite of some improvement in fiscal positions, consolidation requirements to merely stabilise debt are substantial for many countries. The United States and Japan, for which such requirements are among the largest, have yet to produce credible medium-term plans while other countries need to bolster medium-term fiscal targets by specifying the measures that will be implemented to achieve them. For most countries, further action would be needed to bring debt levels back to pre-crisis levels. The overall scenario has changed with respect to the pre-crisis situation when a significant contribution to fiscal sustainability came from the fact that interest rates were well below growth rates. This is unlikely to be the case in the years to come as interest rates will rise and growth could be slower. Structural reforms, while boosting growth, can also help fiscal consolidation by increasing efficiency in the provision of key services such as health and education. Finally, it would be dangerous to believe that higher inflation could address debt sustainability. Higher and persistent inflation could damp real growth by raising price and exchange-rate volatility. It could also risk unhinging inflation expectations, with the result that interest rates would soon increase more than inflation.

Last but not least, imbalances have been widening again as the global economy is recovering. They show, however, a somewhat different configuration as China's current account surplus is well below pre-crisis peaks due to adverse terms–of–trade movements and less buoyant export performance, and high-saving oil-producing economies see mounting surpluses. A desirable rebalancing mechanism should be growth-enhancing and sufficiently symmetric to avoid putting an excessive burden on deficit countries. Such a rebalancing would require more exchange-rate flexibility, which could also help mitigate inflationary pressures in countries where these are strong, while country-specific structural reforms could help to reduce saving and raise investment in surplus countries, and boost saving in deficit countries. In monetary unions, competition-enhancing reforms of labour and product markets could also facilitate adjustments in external positions.

The policy challenge is not to eliminate imbalances but to keep them sustainable, so as to facilitate international reallocation of savings in ways that are supportive of growth. This requires open and long-term-oriented capital markets. Structural policies have an important impact on size and composition of capital movements. At the same time there is a need to reconcile open capital markets with the goal of coping with short-term instability through temporary measures. It is important that, including under the auspices of the G20, advanced and emerging economies agree on a framework that would allow such goals to be reconciled.

The global economy is exiting the recession but is not returning to business as usual. The post-crisis economy will have to deal with old and new challenges, while pursuing new, green and inclusive sources of growth. This requires rethinking the policy paradigm as we draw lessons from the crisis.

In framing the new, post-crisis policy paradigm, some of the existing principles underlying policy should be confirmed, such as those related to supply-side responses to boost growth, while recognising that such policies have additional positive effects on rebalancing and fiscal consolidation. The assignment of monetary policy to achieve price stability and a rule-based fiscal policy to achieve sustainable public finances should be confirmed, while the contribution of fiscal institutions to fiscal discipline could be further explored. But additional lessons should be drawn. The endogenous generation of instability and imbalances out of (apparent) tranquillity, a phenomenon common to several if not all crisis episodes, has been dangerously overlooked. This reinforces the need for financial-sector reform and tighter prudential policies, both at the micro and macro levels.

Finally, as a more complex world than what we believed to be the case requires a broader policy tool kit, we also need to take a closer look at how such tools interact and what can be done to enhance synergies. In this vein another lesson from the crisis is that international cooperation is important both in dealing with emergency situations and in shaping the way forward. This requires agreement on common principles, and, if necessary, common rules, while allowing for country-specific needs. As we slowly leave the crisis behind us, we should be wary of the risk of losing impetus in the search for better global economic governance.

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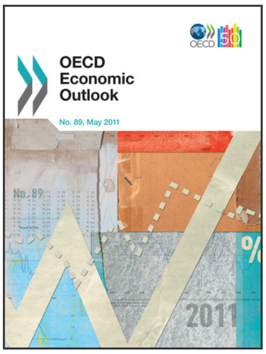

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